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Dear Mr Anderson

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Review of gas distribution network reference tariff variation mechanism and declining block tariffs — Issues paper — 5 May 2023

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts across eastern Australia. We also own, operate and contract a diversified energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 5,000MW of generation capacity.

EnergyAustralia appreciates the opportunity to participate in the AER's review of gas distribution network tariff structures and tariff variation methods (the review). We believe that decarbonisation will only be feasible with high degrees of electrification, with large swathes of mass market customers reducing gas usage and disconnecting from gas networks. This means that a significant proportion of gas network assets will inevitably cease to have market value. Fundamental changes to the regulatory framework will be needed to ensure those customers that cannot switch fuel types are not excessively burdened by having to pay for the entire value of regulatory asset bases.

We encourage the AER to engage with stakeholders on its regulation of these assets and note this recent review follows from the information paper it released in November 2021.[1] The AER is uniquely placed to provide insights into various commercial and customer impacts arising from gas asset stranding in a regulated price setting. Its recent round of access reviews for gas distribution networks in NSW, ACT and now Victoria highlight that concrete solutions to these issues will require clearer direction from policy makers and cannot be solved within the existing National Gas Rules (NGR). It is not sustainable for network businesses to continue to invest in existing and new assets as a business-as-usual approach, or to provide option value in the unlikely scenario that renewable gases can be delivered commercially and at scale. We appreciate the AER is constrained in its roles and for this review is responding to stakeholder suggestions on pricing issues. These issues inevitably lead to other areas of gas network regulation, which we have commented on below as part of an ongoing and wider policy discussion.

[1] AER Information Paper - Regulating gas pipelines under uncertainty - 15 November 2021.pdf

The AER should anticipate a full set of rule changes under an amended NGO

One of the drivers for the AER's review is that it anticipates making decisions on tariff design under an amended National Gas Objective (NGO) that recognises emission reduction targets.

The recent information paper prepared by Senior Officials noted that a set of "priority" rule change requests will be lodged with the AEMC, with an aim to have rules in place by early 2024.[2] Indicative rule amendments appear to be limited to expenditure assessments. This information paper was released after the commencement of the AER's review. It now seems that a current focus on tariff design is out of sequence with anticipated rule changes, that is, there may be more benefit in early consultation on the AER's assessment of gas network expenditure proposals.

Priority rule amendments notwithstanding, it does not seem feasible to make selective rule changes given various components of revenue determinations are interdependent. For example, isolated amendments to rule 79 of the NGR regarding capital expenditure criteria could result in the AER disallowing spending that is inconsistent with emissions reduction targets, while at the same time assessing demand forecasts and other cost drivers under 'old' rules, which themselves might be inconsistent with an amended NGO. It therefore seems likely that the AEMC would make consequential amendments in considering any prioritised rule change proposal, including to rules governing depreciation, the rate of return and tariff design principles, in order for access determinations to be internally consistent.

The AER's current review of pricing issues can inform upcoming rule change processes by analysing linkages between tariff design and other elements of determinations, some of which were canvassed in its 2021 information paper. For example:

- discouraging gas usage and new connections through tariff design will feed back into expenditure assessments and depreciation
- changes to the form of control affecting risk allocation may potentially affect the return on capital
- some rules may require more prescription to accommodate uncertainty in forecast inputs that affect tariff structure and form of control decisions, notably rule 74 which is currently broad in its application
- rules governing pricing structures and overall price levels may need to better differentiate between customer segments. The inability for some customers to switch away from gas fuel, or without external government support, could be addressed by reconsidering how costs are allocated and recovered across different asset classes, with potential feedbacks on depreciation and asset base calculations.

Incentives under declining block tariffs

We agree with stakeholder observations that encouraging consumption through declining block tariffs would likely be inconsistent with government decarbonisation policies and emissions reductions targets. To the extent the AER would regard this solely in the context of an

[2] https://www.energy.gov.au/sites/default/files/2023-06/Incorporating%20an%20emissions%20reduction%20objective%20into%20the%20national%20energy%20objectives%20-%20Information%20Paper.pdf

amended NGO, it would need to balance emissions targets against price, reliability and other elements therein.

These trade-offs are already seen in the AER's recent decisions, which reflect the growing need to address price pressures over the medium term caused by customer switching and asset stranding due to emissions reduction targets. At present this is being done primarily by carefully calibrating rates of accelerated depreciation. We do not consider this approach represents a feasible long-term solution. Unless entire segments of network can be decommissioned in line with reduced utilisation and customer connections, network owners will continue to spend on long-lived assets for safety and other reasons, compounding price pressures and the consequences of asset stranding.

The AER may anticipate rule change proposals or regulations around explicitly valuing emissions reduction, as flagged in the Senior Officials' recent information paper. Should a shadow price of carbon form part of the AER's decision-making framework for expenditure assessments, it could also use this value to inform tariff structure decisions on a cost-benefit basis. That is, different price structures would affect gas consumption, with associated changes in emissions that could be valued using a shadow carbon price. This environmental cost or benefit could be compared against changes in average price levels or customer bills.

A complicating factor in setting network tariffs is the extent to which retailers pass through signals in retail tariffs. The dilution of price signals is important to consider when designing network tariffs, their feedback effects on demand forecasts and associated expenditures. Network businesses already accommodate this in modelling for their revenue proposals. Mandating retail pricing structures to reflect underlying network pricing appears to be beyond the scope of the AER's review and powers. We would oppose this level of prescription in any case. Retail prices reflect a range of underlying costs which include non-network elements and can differ quite considerably between retailers and for different customer segments. Moreover, price and product differentiation are signs of competition and should generally be encouraged. As noted below, we consider that switching rebates and abolishment fees, as well as general customer communications regarding the transition, would be more effective in influencing consumption behaviour than tariff restructuring.

A further consideration in tariff design is whether network haulage tariffs should be restructured away from the underlying carbon-intensive commodity, and be reconfigured towards capacity, which would better align with the cost drivers of network services. One rationale for having declining block tariffs is that it encourages better capacity utilisation, which is approximated by consumption for various practical reasons. This could be revisited under an amended NGO or amended pricing rules.

Incentives under a weighted price cap

We consider that price cap forms of control are inconsistent with emissions reduction objectives. Price caps encourage network businesses to profit maximise by trying to increase customers' consumption. We believe that this incentive is stronger than the underlying theory in price cap regulation, whereby entities exposed to higher volume risk mitigate this by efficiently aligning prices to underlying cost structures. As noted above, network costs are mostly fixed and there are additional practical reasons why theoretically efficient pricing is not seen in reality.

The AER's issues paper raises broader and long-standing issues which in our view warrant consideration of revenue caps or at least hybrid control mechanisms:

- on face value, Figure 1 in the AER's issues paper illustrates there is a systematic bias in the price control framework in that networks persistently and materially over-recover revenues. Over an 11 year dataset, we would have expected to see at least one instance of an under-recovery to illustrate the symmetrical effects of genuine forecast error. The AER's deliberations on this matter should be based on detailed analysis of the drivers of such over-recoveries and also disaggregated for individual networks.

- as the AER would be aware, price caps provide a gaming opportunity for networks to under-forecast sales volumes, which would be a contributing factor to the aforementioned over-recovery of revenues. As the bounds of uncertainty in forecasting volumes are now growing wider as part of the energy transition, this increases the consequences of forecasting bias i.e. it is open to networks to propose very low volumes from the range of plausible outcomes, leaving them more likely to gain if out-turn volumes are higher.

- the drawback of revenue caps, whereby networks face less incentive to pursue efficient pricing, can be as easily managed by providing tighter prescription or oversight in tariff structures. Another drawback of revenue caps in the face of material errors or bias in sales forecasts is that they result in higher price volatility. This would be addressed by moving pricing structures towards more fixed components.

In the presence of elevated uncertainty in gas demand (which may not be as pronounced over a five year access period) the AER should explore hybrid mechanisms which provide bounds of risk for networks and customers, as it seems that neither party is absolutely best placed to manage forecast error. In practice we note that virtually all price and revenue control mechanisms are of a hybrid type as they allow pass throughs, incentive penalties or rewards and a range of other ex post adjustments. Uncertainty arising from policy interventions, such as banning new connections, or incentives for gas switching that have 'step change' effects on demand, seem better accommodated by reopener provisions particularly as expenditure needs are also affected.

Related pricing matters

Gas networks offering incentives for customers to upgrade gas appliances, or to replace electrical with gas appliances[3] should be prohibited.

The AER should set out broader guidance on charging exit or abolishment fees. We note its comment that socialising abolishment fees as part of its Victorian distribution access decision is only an interim measure[4] and we look forward to working with it and other stakeholders on a more sustainable solution.

Although the AER is primarily focused on cost recovery and pricing incentives for network assets, it may be useful for it to consider aligning pricing incentives towards broader gas supply issues. This would fall under the reliability and safety elements of the NGO. Aside from generally encouraging gas conservation to address the risk of annual shortfalls, it could consider more granular price settings to address seasonal and even more narrow peak times during winter scarcity events.

[3] Energy crisis: Gas company offers cash to plug electric exodus (smh.com.au)
[4] AER decision supports Victorian gas consumers in energy transition | Australian Energy Regulator

As the AER has noted, it might not be appropriate to apply the same tariff structures and incentives to mass market customers, who are able to switch fuel sources, versus large industrial customers, where gas fuel is a necessary feedstock. Even over the short to medium term, tariff settings that discourage gas usage may be punitive for mass market customers who face higher cost barriers in appliance switching.

The AER makes a comment on stranding risk on the customer side, in terms of the risk of eroding the value of customer investments in gas appliances and related assets. This risk is best mitigated by providing clear and consistent messaging to customers that electrification (wherever possible) is the inevitable least cost and sustainable pathway. Gas network owners and their representatives appear to be communicating the opposite.[5]

If you would like to discuss this submission, please contact me on [redacted] or [redacted].

Regards

Lawrence Irlam
Regulatory Affairs Lead

[5] See various materials from Energy Networks Australia, for example Revealing the hidden costs of electrification | Energy Networks Australia